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Paradise lost: Bankwest clients want answers from banking royal commission

by James Eyers

It is nine years since Rory O'Brien's luxury development at Whisper Bay, on the tropical Whitsunday coast of Queensland, was placed into receivership by Bankwest, four months after the lender was acquired by Commonwealth Bank in the depths of the global financial crisis.

But the passage of time has failed to assuage the deep sense of betrayal and anger O'Brien feels towards CBA. He's hoping the banking royal commission – which said last week its next target will be lending to business – will investigate why Bankwest abruptly called in his loan in April 2009 even though his project was finished and he'd put a solid plan in place to repay the loan and protect the resort's commercial value amid the economic turmoil.

O'Brien is not alone in feeling hard done by Bankwest: dozens of aggrieved customers have taken legal action since the GFC and petitioned recent inquiries, alleging CBA moved too quickly and aggressively to default loans rather than supporting borrowers through the crisis.

The overall number of borrowers affected remains unclear, but CBA told a parliamentary inquiry in 2015 that it wrote off $1.7 billion of Bankwest loans in the six-and-a-half years after its acquisition of Bankwest of borrowers that had been meeting their obligations to the bank at the time of the deal. Bankwest appointed receivers to 461 borrowers between 2008 and 2012. A comprehensive CBA review of security valuations for 1200 Bankwest loans known as Project Magellan, which began in 2010, resulted in CBA significantly increasing loan impairment provisions in the years after the takeover.

48 hours to repay

O'Brien is not naive that the world of finance changed fundamentally in 2008 and caused upheaval for banks, as commercial property prices plunged. He suggests CBA's conduct towards him fell short of what the community would expect of the nation's largest lender even as it was managing the worst financial crisis in a generation. He says Bankwest's demand he repay $175 million in 48 hours after providing repeated assurances that funding would continue was unfair and unreasonable.

"Banks stock in trade is people's homes and businesses, their livelihoods and lives," O'Brien says. "Banks have a duty to act diligently, expeditiously and professionally. Customers should be treated with reasonable fairness. During the GFC, all banks were under huge pressure. There were seismic shifts in markets. But to say this was risky lending [by Bankwest] is a poor attempt at a post rationalisation cover up."

Last week, the Hayne commission said it would examine lending to small and medium-sized enterprises when its public hearings begin again on May 21. It remains to be seen whether loans as large as O'Brien's will feature or whether the inquiry will choose to pry into the treatment of Bankwest customers after the CBA takeover at all.

But if it does the commission will enter one of the greatest unresolved and highly contentious episodes in Australia's banking history. An investigation into impairment of customer loans by the Parliamentary Joint Committee on Corporations and Financial Services, which reported in May 2016, heard theories from aggrieved borrowers – including O'Brien – that CBA had been motivated to default loans because of a "clawback" provision that allowed the price of Bankwest to be reduced by the amount of any impaired loans on Bankwest's books at the time the deal was completed in December 2008. CBA has consistently and strenuously denied it was motivated to default customers by any clawback.

An inquiry on the post-GFC banking sector by the Senate Economics References Committee in 2012 heard similar allegations but found the market ructions a better explanation than any clawback. An examination of lending to small and medium business by the Australian Small Business and Family Enterprises Ombudsman (ASBFEO) also looked at the issue.

How to quickly boost capital requirements

Kate Carnell, who runs the ASBFEO, has met with the counsel assisting the royal commission to encourage it to investigate the behaviour of CBA and Bankwest after the takeover. She says that even if clawback was not a motivation, the royal commission might consider whether decisions by bank boards of directors to lift capital ratios in the wake of the financial crisis forced bank managers to cut away less profitable loans with higher "risk weightings", such as business loans, given reducing "risk weighted assets" can improve the capital ratio without have to raise extra capital from investors.

If the royal commission doesn't tackle Bankwest, she suggests arguments for another banking royal commission might emerge in the future. "This is a significant issue that has loomed large in parliamentary inquiries, and has never been satisfactorily resolved. If the royal commission doesn't touch it, it would be quite unusual," she says. "Indeed, if the commission doesn't put it to bed, the issue won't go away."

Bankwest customer claims have also had a sympathetic ear from senior members of the Coalition, including Nationals member John Williams and former Liberal MP Philip Ruddock, who prompted the government to launch the parliamentary joint committee inquiry into Bankwest loan impairments after approaches from Liberal Party branch presidents in his electorate. At the inquiry, Ruddock raised the spectre of a royal commission with CBA executives, suggesting it might be necessary to get to the bottom of the customer allegations.

Ruddock's successor in the northern Sydney seat of Berowra, Julian Leeser, told the House of Representatives the week after the royal commission was called by the government last December, that he had been concerned for years about the circumstances surrounding the takeover of Bankwest but previous inquiries didn't have the powers or forensic examination skills of a royal commission.

"These cases need to be properly adjudicated by a qualified person who'll be able to test the claims and counterclaims of the victims and bank executives," Leeser told the parliament.

"I'm pleased that aggrieved customers will now have their voices heard and their claims tested by retired High Court judge Ken Hayne ... The central allegation of the Bankwest victims is that the Commonwealth Bank, in exercising their power under these [loan] agreements, acted in a way that might entitle the victims to the right to equitable relief for unconscionable conduct."

Any finding by the commission that CBA or Bankwest acted unconscionably could expose them to substantial claims for damages.

'We ticked all the boxes'

O'Brien was on a fishing trip with mates in 2005 when he decided to build at Whisper Bay, a 15-minute walk around the Abell Point Marina to Airlie Beach. It is now a popular destination for global backpackers renowned for its expansive lagoon pool, vibrant bars and lackadaisical vibe.

An experienced developer with more than 35 years' experience and no losses on previous projects, O'Brien and another investor put in $20 million of cash equity. Westpac Banking Corp offered financing but O'Brien went with Bankwest following a year-long due diligence process during 2006. "We ticked all the boxes," he says. "Their forensic examination was very tough and exacting and we passed in all aspects with flying colours. Banks simply don't advance $175 million without being very careful indeed."

The project financing relationship between commercial developer and bank is different to a normal retail loan, where borrowers repay principal and interest during the life of the loan. Because interest was capitalised, O'Brien wasn't expected to make repayments and relied on Bankwest to pay all the constructions and other development costs. The bank would be repaid when the villas were sold and the bank could decide to "roll over" the original loan to a lower amount when it expired.

Construction started in February 2007. The 104 villas have expansive views across the Coral Sea to Hayman Island on the horizon and were finished with high-quality fittings and private pools. Buyers off the plan included former prime minister Bob Hawke, the Queen's stockbroker Chris Palmer Tomkinson, the former owner of Dendy cinema chain Richard Becker, businessman Alan Thiess and Sydney property agent Bill Malouf.

Half of the villas were sold before or during construction, and the project was completed on time and on budget at the end of November 2008. O'Brien says pre-sales totalled $106 million; 10 per cent deposits had been paid. CBA told the parliamentary joint committee it considered pre-sales were closer to $50 million, but O'Brien maintains he had enforceable contracts that would have allowed funds to be collected and the original $175 million facility to be refinanced at about $75 million at the start of 2009.

In order to settle the contracts, O'Brien needed a resort manager in place because the property would be operated as a 5-star hotel. After moving to the United Arab Emirates in June of 2008 to seek to capitalise on growing interest in quality Australian tourism assets by Middle East airlines Emirates, Ethiad and Qatar, O'Brien signed a memorandum of understanding in November with the hotel group Essque – controlled by the Dubai royal family – to manage Whisper Bay.

"Essque Hotels decision to invest in the management business has not been taken lightly particularly given the current state of the global economy," its CEO Danny Haddad told O'Brien in December. "Essque Hotels does however clearly recognise the long-term value of the management asset opportunity at Whisper Bay and will reap the rewards in the future as the brand and area matures."

O'Brien was also working on an investment fund, to be managed by Fortis Banque in Dubai, to take out the residual bank debt by buying the unsold villas. In December, Fortis described the MOU with Essque as a "massive vote of local confidence in the quality, location and developer of the project".

Doing the deals

At the same time that Whisper Bay was completed and O'Brien was doing the deals with the Arabs to repay part of the original loan, which was due to expire in mid-December, CBA bought Bankwest.

After an aggressive period of expansion on the east coast, Bankwest had a $23 billion commercial loan book with around half its assets in commercial property. The bank was in deep trouble due to mounting concerns its embattled UK parent, HBOS, would not be able to continue to provide funding support. During the first week of October, then CBA chief executive Ralph Norris made an offer for Bankwest: CBA would pay $2.1 billion and assume responsibility for about $19 billion in wholesale funding.

The share sale deed between HBOS and CBA contained a mechanism to allow CBA to adjust the purchase price to reflect the value of any impaired loans at the time the deal settled on December 19. Such clauses are common in transactions with short due diligence periods.

Under parliamentary privilege at the parliamentary joint committee hearings in 2015, O'Brien argued this "clawback" clause was exploited by CBA as a more efficient option than working with him to settle all the sales, get the hotel management in place, launch the investment fund, and roll over the loan. Immediately following the takeover by CBA, he said Bankwest had uncharacteristically begun stalling time-critical decisions and delaying vital payments to project consultants.

O'Brien argued that since CBA already had a large commercial loan book and had not paid much for Bankwest, it decided to "rationalise" the Bankwest book by terminating unwanted loans and "freezing" decisions relating to rolling over funding. He argued this ensured Whisper Bay's demise, and created the default. CBA categorically rejected the accusations, arguing the level of pre-sales were overblown, the MOU with Essque was non-binding and there were other financial pressures on the development.

Documents provided to the parliamentary joint committee show a claim of $46 million was made under the price adjustment mechanism in the HBOS sales contract by CBA against Whisper Bay. CBA says this reflected the amount it believed the loan to be impaired by, as at December 19. But CBA's claim was knocked back by HBOS, its advisers KPMG and an independent arbitrator, Ernst and Young.

What is reasonable impairment?

The final report of the parliamentary joint committee in 2016 said it was not able to determine whether CBA's impairment of loans was solely motivated by clawbacks but it said this could have been a cause of delays to determining whether projects like O'Brien's should receive funding, effectively leaving them in limbo. "The technical decision on whether they were impaired may have been left undetermined for many months throughout the sale negotiations and price adjustment process," the committee said. "For the affected businesses, that elapsed time without action to address financial difficulties possibly compounded their problem."

O'Brien says that with one of the best hotel operators in the world enthusiastically ready to manage the property, with over $100 million in sales to high net worth individuals, and a Middle East-based investment fund ready to invest in the rest, the conduct of CBA and Bankwest "was totally outside standard operating procedure. It was outrageously nonsensical for a bank not to pull the trigger. They didn't engage. It was uncommercial."

He also reckons it was misleading for Bankwest to tell representatives of Essque – who were in Australia preparing to get the property ready for its first tourist arrivals in July – in late February, and again March, that funding would continue. O'Brien says "if there is a problem, they should be calling you in immediately for a meeting to talk about it. To the contrary, they were telling everyone everything is OK and to trust them."

But everything wasn't OK: time was up for Whisper Bay. On April 6, Bankwest's lawyers sent a letter of demand giving O'Brien 48 hours to repay $178 million. He scrambled to try to find alternative financing, but markets remained volatile and there wasn't enough time. The bank appointed receivers Korda Mentha on April 20.

"You can't litigate against the banks"

In 2010, the project – advertised as "the finest example of a luxury resort on Australia's east coast" – was sold to Chinese company Fullshare Holdings for $56 million. This represented half the value of the actual pre-sales according to O'Brien, 30 per cent of the development cost, and 20 per cent of the valuation conducted by Bankwest's own valuer Savills in mid-2008 – of $255 million.

Like several other big Bankwest borrowers whose loans were also called in, the matter went into hard-fought litigation. CBA sued O'Brien for the difference between the sale price and the loan – $122 million – in March 2011. He counterclaimed for $512 million, an amount that included the value of a future pipeline of projects with his Arab connections.

Initially, CBA relied on "suspension clauses" in its loan contract to try to prevent O'Brien from continuing with the case until the bank was fully repaid the disputed amount. O'Brien won this case on appeal but says he was forced to settle with CBA in April 2014 when he ran out of funds to continue the fight. The settlement was for $100,000, and O'Brien made a joint statement with CBA saying his clawback allegations were without foundation. But he says now: "You can't litigate against banks. They burned me on time, massive cost and stress. The court system doesn't work."

The long-running saga has inevitably had a deep human cost. O'Brien says his reputation, career and finances were obliterated overnight. He suffered the shame of his family home, which had been pledged as security, being sold by receivers at public auction. His wife left him, along with their two daughters.

The search for motivation

Seasoned property experts were left scratching their head about what might have motivated CBA to act like it did. Former Mallesons property partner Michael Allen, who worked for O'Brien, said in a Supreme Court affidavit that "I had never before experienced a financier apparently abandoning sales contracts that represented such a significant part of its security in project. This curious conduct continued up to the appointment of the receiver the following month."

Commonwealth Bank says it will be up to the royal commission to decide whether it will look at O'Brien's case. The bank said in a statement to *The Australian Financial Review*: "As we have made clear previously, there is no connection between what happened to Mr O'Brien's development and the terms of the deal to buy Bankwest. There was no benefit to CBA from the failure of Mr O'Brien's development: to date we have written off $93.6 million on the project."

Regardless of whether the royal commission decides to reopen the wounds between O'Brien and CBA, small business ombudsman Kate Carnell says submissions from many Bankwest customers to her loans inquiry last year show the ramifications of CBA's conduct have been large. "Many business people lost their jobs, businesses went under, families broke up, and people's mental health was affected," which justifies the royal commission asking questions about CBA's conduct during the large-scale provisioning process.

Unpublished analysis by the ASBFEO, prepared after its inquiry with input from regulators and provided to the *Financial Review*, raises another possible explanation for CBA's conduct.

The ASBFEO points to the decision by the the CBA board in February 2009 to lift the internal "Tier 1 capital ratio target" to above 7 per cent, from a previous range of between 6.5 per cent and 7 per cent, and suggests this could have created pressure on CBA management to reduce risk-weighted assets (a way to increase the capital ratio in the absence of raising more capital).

Capital requirements over consumers?

The ASBFEO suggests the higher target may have created an "enhanced appetite for corporate and SME Bankwest loans to be written off" and this may explain why the bank "did not demonstrate a willingness to genuinely work with corporate and SME customers to 'rehabilitate' any of the loans being targeted". It says this potential motivation for terminating performing loans is worthy of more investigation.

Last week, the royal commission published a background paper on the regulatory capital framework for banks, prepared by the Australian Prudential Regulation Authority, which includes analysis of capital requirements for business loans. This suggests the impact on borrowers of regulatory capital decisions by regulators and banks may feature in the upcoming round of royal commission hearings.

During its business lending hearings, the commission may also be interested in potential breaches of the Banking Code of Practice when banks stop funding of business customers, and the relationship between banks and liquidators and receivers and their legal advisers in the context of workouts with business borrowers.

Tackling CBA's handling of the integration of Bankwest loan book would more challenging territory for the commission than the case studies it has examined on irresponsible lending and financial advice, Carnell suggests. In part that's because business lending is largely unregulated, so establishing misconduct and proving unconscionability is very difficult.

"But there is a reason the royal commission should look at this," she says.

"Even though bank lending contracts allowed them to behave the way they did, did it meet community expectations for a bank to seek to get its money back quickly, rather than working with customers over the longer term? Is it reasonable and within community expectations – even in a financial crisis – for banks to bankrupt people who are repaying their loans, or doing what they are supposed to be doing?

"It is easier to say risk doesn't stack up, but it is much harder to work with borrowers to bring them through a crisis."

CBA, like the other major banks, received taxpayer support during the financial crisis in the form of the government guarantee of customer deposits and a wholesale funding guarantee. O'Brien says a quid pro quo for such support should have seen CBA using its financial clout to support small business through the challenging period.

"People like me take risks for the country," he says. "We need a tourism industry and it is, and should be, a major export earner. I had the foresight to get this region going. I decided to put my own money on the line, but you expect fair treatment. If I stuffed up, it would be a different story, and I could cop that. But I didn't. I did everything exactly as I had agreed with Bankwest.

"There are thousands of Rorys. There were many good businesses that relied on continuing bank support, but didn't get it."

CBA